

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:MSR:ILD:TL-N-6235-99

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date: November 23, 1999

to: District Director, Illinois
Attn: Robert Maio
Case Coordinator E:1102

from: District Counsel, Illinois CC:MSR:ILD

subject: Patent Litigation - [REDACTED] ([REDACTED])

I. Issues:

A. Is an amount paid under a settlement agreement in lawsuit involving litigation over alleged patent infringement deductible as ordinary and necessary business expenses, or should they be capitalized?

B. Are legal costs incurred for lawsuits involving litigation over alleged patent infringements deductible as ordinary and necessary business expenses, or should they be capitalized?

II. Conclusions:

A. The payment should be capitalized against the licenses acquired by the taxpayer, and amortized over the remaining bases of the licenses.

B. The costs for the [REDACTED] litigation should be capitalized and treated in the same fashion as the settlement payment. The costs in the [REDACTED] litigation should be allowed as ordinary and necessary business expenses.

III. Facts:

The taxpayer is a multinational company engaged in the business of manufacturing & selling a wide variety of products relating to [REDACTED] and [REDACTED] equipment, as well as using that property in the conduct of its own [REDACTED] business.

During the years at issue, the taxpayer had disputes with unrelated third parties concerning the taxpayer's use of manufacturing processes and/or technologies, allegedly in violation of patents held

by the third parties. These disputes caused the taxpayer to file lawsuits against the third parties. It won one of the cases, and settled the other. On its returns, it deducted all the legal expenses paid in these lawsuits, and it also deducted the settlement amount paid in the case which was settled.

A. The [REDACTED] Case

The first lawsuit was filed by the taxpayer in [REDACTED] against [REDACTED] [REDACTED] himself had previously threatened litigation against the taxpayer for infringement of patents which he held, and the taxpayer's suit was in the nature of a preemptive strike to "thwart an opportunist and invalidate his weapons." The taxpayer specified [REDACTED] of [REDACTED]'s patents, and asked for a declaratory judgment that:

- (1) the patents were invalid;
- (2) the taxpayer had not infringed any of the patents;
- (3) the patents were fraudulently obtained by [REDACTED];
- (4) the patents were unenforceable due to laches (two bases);
- (5) the patents were unenforceable due to intervening rights; and
- (6) the patents were invalid due to double patenting.

The taxpayer's complaint alleged that [REDACTED] had asserted that the taxpayer, by manufacturing various [REDACTED] products and selling them to others, had been infringing on patents he held, and had threatened to sue the taxpayer for an injunction against further manufacture and sale of its products and for damages.

[REDACTED] counterclaimed, specifying [REDACTED] patents which had been infringed by the taxpayer, requesting a restraining order against further violation, and damages for past infringement.

On [REDACTED], the case was settled. At the point of settlement, the patents were owned by the [REDACTED], which was included as a party to the settlement. The [REDACTED] asserted that it owned all patents and patent applications on which [REDACTED] was the named inventor, subject to specific exceptions.

Under the settlement agreement:

- (1) the [REDACTED] granted the taxpayer (called "Licensee") a "nonexclusive and fully paid-up license" under the patents; and

(2) The [REDACTED] agreed not to sue the taxpayer or its customers in connection with the licensed patents, whether for actions before or after the grant.

These clauses were in a section entitled "Grant of License/Covenant Not to Sue." The license granted to the taxpayer was not complete; the taxpayer could not, for example, sublicense the patents.

The term of the license was for the full remaining term of each patent, beginning on the date of the agreement (or when the patent was granted for pending ones.)

Compensation for the above agreements included:

(1) the [REDACTED] was to be permitted to identify the taxpayer as a sponsor of certain awards issued by the [REDACTED];

(2) the taxpayer agreed to make certain specified donations to [REDACTED] not exceeding \$ [REDACTED];

(3) the taxpayer agreed to participate in and co-sponsor certain [REDACTED] programs; and

(4) the taxpayer made a lump-sum payment of \$ [REDACTED] to the [REDACTED], of which \$ [REDACTED] was required to be spent on the co-sponsored [REDACTED] programs.

On its [REDACTED] return, the taxpayer deducted the legal fees and the settlement amounts as ordinary and necessary business expenses.

B. The [REDACTED] Case

On [REDACTED], the taxpayer filed a lawsuit against [REDACTED] seeking a declaration that [REDACTED] patents asserted by [REDACTED] were invalid and unenforceable, and that in any event, the taxpayer had not infringed them. [REDACTED] counterclaimed for infringement of the [REDACTED] patents.

After [REDACTED] conceded that [REDACTED] of the patents were invalid, it asserted [REDACTED] claims of infringement deriving from the [REDACTED] remaining patents.

A jury trial resulted in the verdict that the [REDACTED] of the claims were invalid and were not infringed. The district court reversed as to [REDACTED] of the claims, all relating to one patent, declaring them valid, but did not change the "no infringement" verdict. The Federal Circuit Court of Appeals upheld the trial court, albeit adding [REDACTED] claim, involving a different patent, to the valid but not infringed category.

The taxpayer deducted the legal fees incurred in connection with the district court trial on its [REDACTED] return as ordinary and necessary business expenses.

IV. Discussion

IRC § 162 provides that a deduction from income shall be allowed for ordinary and necessary business expenses paid or incurred during the taxable year in carrying on any trade or business. IRC § 263 provides that no deduction is allowed for capital expenditures. The provisions of § 263 take precedence over the business expense deduction of § 162. See § 161. Thus, the "norm" is capitalization. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992)

A. The [REDACTED] Settlement

The amount paid by the taxpayer to the [REDACTED] was in exchange for the agreement of the [REDACTED] that (1) the taxpayer would have licenses to use any patent originated by [REDACTED] up to the date of the settlement, and (2) the [REDACTED] would not assert any further claims against the taxpayer based on infringement of any of [REDACTED]'s existing patents or patent applications.

While it is possible to consider the Covenant Not to Sue as an intangible asset acquired in the settlement, we believe that in this case the effect of the Covenant is simply to guarantee the rights already inherent in the acquisition of the licenses under the settlement. In the absence of any indication that the Covenant had any material separate value, we conclude that it should be disregarded for tax purposes.

On the other hand, the licenses which the taxpayer acquired are distinct assets which have determinable useful lives. There is, however, no allocation of the settlement amount to any particular license; rather, they are bought "in bulk." It is probable that many of them have nothing to do with the taxpayer's business, and are included in the settlement simply in order to lay to rest all claims, existing and potential, between the parties. Therefore, we recommend that in capitalizing the settlement amount, you only take into account the patent claims actually placed in issue in the litigation.

This leaves the question of the value to be assigned to the license still in issue, and since neither the government nor the taxpayer, nor the settlement agreement, assigns specific values to any of them, it would seem that the only way to deal with valuation is to assign each license its aliquot share of the settlement amount.

In response to your inquiry, the taxpayer provided a schedule which listed amortization for [REDACTED] of the patents involved. The schedule shows amortization beginning in [REDACTED] for the earliest patent, and all the patents are shown as beginning amortization prior to [REDACTED]. The schedule reflects an initial deduction of all accumulated amortization in [REDACTED], and schedules yearly amortization deductions for each patent for all subsequent years.

The problems with this schedule are obvious. The allocation of the license costs is made equally to each patent, and only eight patents are covered. At a minimum, the schedule should incorporate licenses for all seventeen of the patents actually alleged as infringed in the pleadings. Furthermore, Since there is no mention of damages for past infringement in the settlement, the entire amount of the settlement should be assigned to the remaining lives of the licenses, and amortized accordingly.¹

B. The Legal Costs

In determining whether litigation costs are deductible, the origin and character of the claim with respect to which an expense is incurred is the controlling test. United States v. Gilmore, 372 U.S. 39 (1963). To the extent that the costs relate to the recovery of lost income, they are deductible; however, to the extent that they are associated with a contest regarding the taxpayer's property interest, they are capital. See Urquhart v. Commissioner, 215 F. 2d 17 (3rd Circuit 1954)

It is a "well-worn notion that expenses incurred in defending a business and its policies from attack are necessary and ordinary -- and deductible -- business expenses." A.E. Staley Manufacturing Company v. Commissioner, 119 F. 3d 482 (7th Cir. 1997).

In determining the character of the claim, it is necessary to examine the particular circumstances of each case. In both the [REDACTED] and the [REDACTED] situations, the underlying question was whether the taxpayer had the right to use certain technologies or processes in the manufacture of products which it sold, or used in its [REDACTED] business. The taxpayer was defending its right to use these technologies or processes against third parties who claimed ownership of them.

While the two situations have much in common, the outcomes were materially different. In the [REDACTED] situation, it was established that the claimed property interest did not exist. Therefore, it can be concluded that the litigation expenses were simply for the purpose of defending the taxpayer's business against [REDACTED]'s potentially damaging assertion of non-existent rights against the taxpayer. The taxpayer was not defending its right to use property; rather, it established that there was not any property in existence which could be used in the first place. Under these circumstances, the legal expenses are deductible.


In the [REDACTED] situation, however, the taxpayer settled the case and paid for the right to use the property. From this outcome, it can be seen that the taxpayer, for purpose of settlement, conceded that it would be using patented processes in the future, and the legal costs were incurred in defense of

¹ The settlement agreement does not mention damages for past infringement, so there is no basis in the documents to conclude that any portion of the settlement amount is immediately deductible. This does not mean, of course, that an agreed disposition of the adjustment involved here might not incorporate some measure of damages for which the taxpayer would have an immediate deduction.

that future use. Since, as an outcome of the litigation, the taxpayer received licenses for the future use of the property, the costs should be included in the basis of the licenses.

This advice has been informally coordinated with Russ Pirfo in our National Office. It is subject to post-review, which should normally be finished in the next two weeks. If the National Office recommends any material change or addition to this advice, we will advise you immediately.

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